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STATEMENT ON AUDITING PROCEDURE

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Reports on Internal Control

1. Independent auditors are sometimes requested to furnish reports on their evaluation of internal control for use by management, regulatory agencies, other independent auditors, or the general public. The purpose of this Statement is to improve the understanding of such reports with reference to the nature and effectiveness of internal control and the independent auditor's evaluation of it.

2. As used in this Statement, *management* includes directors, officers, and others who perform managerial functions; *regulatory agencies* include both governmental and other agencies, such as stock exchanges, that exercise regulatory, supervisory, or other public administrative functions; and the *general public* includes present and prospective investors, creditors, customers, and others who have an interest in particular organizations.

3. This Statement supplements, but does not supersede, Chapter 5 of Statement on Auditing Procedure No. 33, which also deals with internal control.

*Issued by the Committee on Auditing Procedure
American Institute of Certified Public Accountants*

Nature and Effectiveness of Internal Control

4. Internal control is described in Statement on Auditing Procedure No. 33, Chapter 5, paragraph 5 as follows:

In the broad sense, internal control includes . . . controls which may be characterized as either accounting or administrative, as follows:

- a. Accounting controls comprise the plan of organization and all methods and procedures that are concerned mainly with, and relate directly to, safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.
- b. Administrative controls comprise the plan of organization and all methods and procedures that are concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls.

5. The establishment and maintenance of a system of internal control is an important responsibility of management. In exercising this function, it is appropriate for management to recognize that the cost of internal control should not exceed the benefits derived. The benefits consist of reductions in the risk of failing to achieve the objectives implicit in the definition of internal control. Although the cost-benefit relationship is the primary conceptual criterion that should be considered in designing a system of internal control, precise measurement of costs and benefits usually is not possible; accordingly, any evaluation of the cost-benefit relationship requires estimates and judgments by management.

6. There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal control. In the performance of most control procedures errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends on segregation of duties can be circumvented by collusion. Similarly, control procedures can

be circumvented intentionally by management with respect to (1) the execution and recording of transactions or (2) the estimates and judgments required in the preparation of financial statements.

7. For the reasons discussed in paragraphs 5 and 6, it is evident that a satisfactory system of internal control can be expected to provide reasonable, but not absolute, assurance that its objectives will be accomplished. Conversely, weaknesses in a system do not necessarily mean that errors and irregularities will occur.

8. In addition to the limitations discussed above, any projection of a current evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

Purpose and Scope of Auditor's Study and Evaluation

9. The purpose of the auditor's study and evaluation of internal control incident to his examination of financial statements is to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied. This is expressed in the second standard of field work included in the generally accepted auditing standards (Statement on Auditing Procedure No. 33, Chapter 2, paragraph 2) adopted by the profession, as follows:

There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

Suggestions for improvement in internal control frequently arise from audit engagements and may also arise from special engagements undertaken for that or other purposes.

10. The subdivision of internal control into accounting control and administrative control was made primarily to clarify the scope of the study required under generally accepted auditing standards. The conclusions in that respect, as expressed in Statement on Auditing Procedure No. 33, Chapter 5, paragraph 21, were as follows:

The independent auditor is primarily concerned with the accounting controls. Accounting controls, as previously described, generally bear directly and importantly on the reliability of financial records and require evaluation by the auditor. Administrative controls, also previously described, ordinarily relate only indirectly to the financial records and thus would not require evaluation. If the independent auditor believes, however, that certain administrative controls may have an important bearing on the reliability of the financial records, he should consider the need for evaluating such controls. For example, statistical records maintained by production, sales or other operating departments may require evaluation in a particular instance.

11. The overriding criterion inherent in the preceding excerpt is the bearing that particular controls have on the reliability of financial records, regardless of their classification as accounting or administrative controls. For practical purposes, this is tantamount to including within the definition of accounting control any administrative control procedures that have been evaluated by an auditor because he believed they had an important bearing on the reliability of the financial records. This concept of accounting control is applied for convenience hereafter in this Statement.

12. The study made as the basis for the auditor's evaluation of accounting control includes two phases, as indicated by Statement on Auditing Procedure No. 33, Chapter 5, paragraph 19:

Adequate evaluation of a system of internal control requires [1] knowledge and understanding of the procedures and methods prescribed and [2] a reasonable degree of assurance that they are in use and are operating as planned.

These two phases of the study are referred to in this Statement as (1) the review of the system and (2) tests of compliance with the system, respectively.

13. Since the purpose of the evaluation required by the second standard of field work is to provide a basis for determining the "extent of the tests to which auditing procedures are to be restricted," it is clear that its purpose is to contribute to the "reasonable basis for an opinion" comprehended in the third standard (Statement on Auditing Procedure No. 33, Chapter 2, paragraph 2) which is quoted below:

Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

14. The evidential matter required by this standard is obtained through auditing procedures designed to test the validity and the propriety of accounting treatment of transactions and balances. The second standard does not contemplate that the auditor should place complete reliance on internal accounting control to the exclusion of other auditing procedures with respect to material items in the financial statements. Consequently, the auditor's review and tests of internal accounting control should be recognized as being only a part of his examination of financial statements.

Usefulness of Reports on Internal Control

15. Because of the technical nature and complexity of internal accounting control and the consequent problem of understanding reports thereon, questions have been raised as to whether such reports serve a useful purpose for all persons to whom they might be issued. The usefulness of such reports depends on the understanding of the reports and on the action that can be taken by those to whom the reports are issued. The expected usefulness to the principal classes or groups of such persons is discussed in the remainder of this section.

Management, Regulatory Agencies, and Independent Auditors

16. Management is responsible for establishing and maintaining internal accounting control. Regulatory agencies may be concerned with such control because it is relevant to their primary regulatory purpose or to the scope of their examination functions. Independent auditors of one entity or organization unit may be concerned with internal accounting control of another because it is relevant to the scope of their examination. It may be presumed that these groups include persons whose training and experience or intimate knowledge of the organization should provide a reasonable basis for understanding the nature and effectiveness of internal accounting control and the auditor's evaluation of it. Consequently, it is evident that reports on

internal accounting control can serve a useful purpose for management, regulatory agencies, and other independent auditors.

General Public

17. In contrast to the foregoing groups, the usefulness of reports on internal accounting control to the general public is questionable. The groups discussed in the preceding paragraph are directly concerned with internal accounting control and are in a position to take direct action as a result of reports thereon. On the other hand, any possible action that could be taken by the general public as a result of such reports would be indirect since it ordinarily would be limited to making decisions about either a company's financial statements or its management. The usefulness of reports on internal accounting control for these purposes is discussed in the next three paragraphs.

18. Insofar as audited financial statements are concerned, the auditor's evaluation of internal accounting control is only an intermediate step in forming the opinion he expresses on such statements. Therefore, an auditor's report on his evaluation of internal accounting control would not provide any additional credibility to audited financial statements.

19. Insofar as interim or other unaudited financial statements are concerned, a report on an auditor's evaluation of internal accounting control for an earlier period could only be used to project the evaluation into the future as a basis for reliance on the unaudited statements. Depending on the evaluation expressed in the report, such projections into the future could either increase or decrease the reliance that otherwise would be placed on the unaudited statements. Some believe that such projections would serve a useful purpose because the public is interested in unaudited statements and because the effectiveness of internal accounting control has a bearing on the probability that such statements will be reliable. Although conceding the relevance of internal accounting control in this respect, others believe that projections of auditors' evaluations thereof would result in either unwarranted reliance on, or unduly negative inferences concerning, unaudited financial statements. The latter group believes that unwarranted reliance would result from improper understanding of the inherent limitations on any system of internal accounting control, of

the purpose and scope of the auditor's evaluation, and of the risks of projecting such evaluations into the future. Conversely, this same group believes unduly negative inferences would result from improper understanding that weaknesses in internal accounting control relate to conditions that could, but would not necessarily, cause unaudited financial statements to be misleading.

20. There are also different views as to the usefulness of reports on internal accounting control for the purpose of making decisions about management's performance. Some believe such reports would be useful for that purpose because internal accounting control is an important area of management responsibility. Others believe the relative importance of this area of management responsibility, as compared to other areas for which reports are not presently available or feasible, is such that reports on internal accounting control alone would result in distorted appraisals of management performance.

21. Although the general public has been defined broadly in this Statement, the Committee recognizes that within this group there may be considerable variation in the degree to which the conflicting expectations expressed in paragraphs 19 and 20 will materialize. This variation may arise from, and reflect differences in, circumstances such as the type and extent of investment or other interest in the organization and the related influence on management action, and the level of understanding of the nature and limitations of internal accounting control.

22. Considering the conflicting views discussed above and the limited experience with such reports, the Committee has concluded that the decision as to whether reports on an auditor's evaluation of internal accounting control would be useful for some portion or all of the general public in particular cases or classes of cases is the responsibility of management and/or any regulatory agencies having jurisdiction.

23. In no event, however, should an auditor authorize a report on his evaluation of internal accounting control to be issued to the general public in a document that includes unaudited financial statements.

Form for Reports on Internal Control

Reports Based on Audits

24. If reports on auditors' evaluations of internal accounting control are to be issued, the Committee believes the risk of misunderstanding can be reduced by adopting a form of report that describes in reasonable detail the objective and limitations of internal accounting control and the auditor's evaluation of it. Therefore, the following language should be used for such purpose except as discussed in the subsequent paragraphs in this Statement.

We have examined the financial statements of ABC Company for the year ended December 31, 1970 and have issued our report thereon dated February 23, 1971.* As a part of our examination, we reviewed and tested the Company's system of internal accounting control to the extent we considered necessary to evaluate the system as required by generally accepted auditing standards. Under these standards the purpose of such evaluation is to establish a basis for reliance thereon in determining the nature, timing, and extent of other auditing procedures that are necessary for expressing an opinion on the financial statements.

The objective of internal accounting control is to provide reasonable, but not absolute, assurance as to the safeguarding of assets against loss from unauthorized use or disposition, and the reliability of financial records for preparing financial statements and maintaining accountability for assets. The concept of reasonable assurance recognizes that the cost of a system of internal accounting control should not exceed the benefits derived and also recognizes that the evaluation of these factors necessarily requires estimates and judgments by management.

There are inherent limitations that should be recognized in considering the potential effectiveness of any system of internal accounting control. In the performance of most control procedures, errors can result from misunderstanding of instructions, mistakes of judgment, carelessness, or other personal factors. Control procedures whose effectiveness depends upon segregation of duties can be circumvented by collusion. Similarly, control procedures

* If the report on an examination of the financial statements is qualified because of any restriction on the scope of the examination, the restriction and its effect on the evaluation of the system of internal accounting control should be indicated in the report thereon.

can be circumvented intentionally by management with respect either to the execution and recording of transactions or with respect to the estimates and judgments required in the preparation of financial statements. Further, projection of any evaluation of internal accounting control to future periods is subject to the risk that the procedures may become inadequate because of changes in conditions, and that the degree of compliance with the procedures may deteriorate.

Our study and evaluation of the Company's system of internal accounting control for the year ended December 31, 1970, which was made for the purpose set forth in the first paragraph above, was not designed for the purpose of expressing an opinion on internal accounting control and it would not necessarily disclose all weaknesses in the system. However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses.

The above paragraphs should be followed by appropriate description of the material weaknesses. The descriptions should indicate whether the weaknesses relate to the prescribed procedures or to compliance with them. The report may also include recommendations for improvements, comments concerning corrective action taken or in process, or other comments appropriate in the circumstances. The basis for any comments concerning subsequent corrective action should be indicated, including the scope of any review and tests by the auditor. Although the Committee believes the first paragraph of the foregoing form of report clearly indicates that weaknesses in the system are considered in determining the nature, timing, and extent of auditing procedures necessary for expressing an opinion on financial statements, some auditors may want to include further comments in this respect.

25. In some cases the auditor may conclude that for certain weaknesses corrective action by management is not practicable in the circumstances and he may decide to exclude such weaknesses from his report. If such weaknesses are excluded, the last sentence of the above form of report should be modified as follows:

However, such study and evaluation disclosed the following conditions that we believe to be material weaknesses for which

corrective action by management may be practicable in the circumstances.

Such a report should include appropriate description of material weaknesses for which the auditor has either (1) concluded that corrective action by management is practicable, or (2) formed no conclusion in this respect.

26. If there are no conditions to be reported in accordance with the two preceding paragraphs, the word “no” should be substituted for “the following” in the above form of report.

27. The auditor may want to report other weaknesses, regardless of his judgment as to materiality or practicability of corrective action by management. The latter might include situations in which the organization is too small to permit adequate segregation of duties of employees. In any of these situations the language in paragraph 24 should be modified as appropriate. If some weaknesses are reported to one group but not to another (for example, to management but not to regulatory agencies or to the general public), the more extensive report should distinguish the weaknesses that are excluded from the other report and the auditor should be prepared to support, if necessary, his judgment in making the distinction.

28. In some cases reports on internal accounting control may include comments on additional matters. For example, a regulatory agency may require comments on certain aspects of administrative control or on compliance with certain provisions in contracts or regulations. In such cases the language in paragraph 24 should be modified to identify clearly the additional matters and distinguish them from internal accounting control, to describe in reasonable detail the scope of the review and tests concerning them, and to express conclusions in language comparable to that in paragraphs 24 through 27 as appropriate. The identification of the additional matters covered in the report should be as specific as the auditor considers necessary to prevent misunderstanding in this respect. Such identification can be made in some cases by reference to specific portions of other documents such as contracts or regulations.

29. Since auditors are aware of the objective and limitations

of internal accounting control and of auditors' evaluations of it, use of the form of report in paragraph 24 is optional for reports issued solely for another independent auditor.

30. Use of the form of report in paragraph 24 is optional also for reports issued solely for the internal information of management. Suggestions or other comments concerning specific aspects of internal accounting control and various other matters are often submitted to management by auditors as a result of observations made during their examinations of financial statements. These comments are often submitted by letters, memoranda, and other less formal means. The Committee encourages this practice and this Statement is not intended to preclude the use of such means of communication.

Reports Based on Special Studies

31. Reports on internal accounting control sometimes are issued as a result of special studies. As used in this Statement, *special studies* are those in which the scope of the study and evaluation being reported is substantially more extensive than that required for an examination of financial statements in accordance with generally accepted auditing standards. Special studies may relate either to an existing system or to a proposed system.

32. If reports on special studies of internal accounting control are to be issued to regulatory agencies or to the general public, the form of report in paragraph 24 should be adapted by replacing the first paragraph and modifying the fourth paragraph therein. The first paragraph should describe the purpose and scope of the study. This description should be in reasonable detail and should indicate whether the scope included both a review of the system and tests of compliance with it. The fourth paragraph should be modified to refer to the purpose of the special study and any related limitations and to refer to the weaknesses disclosed or the absence thereof by using the language included in paragraphs 24 through 26 as appropriate in the circumstances.

33. For reports issued solely for use by management or other independent auditors, the flexibility in reporting provided for

in paragraphs 29 and 30 applies also to reports based on special studies.

The Statement entitled "Reports on Internal Control" was adopted by the assenting votes of seventeen members of the Committee, of whom three, Messrs. Gomprecht, Hepp and Krebs assented with qualification. Messrs. Fitzgerald, Kell, Kist and Magill dissented.

Mr. Gomprecht assents to publication of this Statement, but dissents to paragraph 22 which permits issuance of reports on internal control to the general public. He believes reports on internal control should not be issued to the general public and that such reports issued to regulatory agencies should be confidential. He does not believe that there is broad understanding of the nature of internal control and its relationship to financial statements and the auditor's examination. In his opinion, reports on internal control are of such a technical nature that they would be meaningful to relatively few outside of management, regulatory agencies and the accounting profession. Accordingly, Mr. Gomprecht believes that public dissemination of reports on internal control would lead to improper inferences being drawn therefrom and, thus, would be misleading.

Mr. Hepp assents to publication of this Statement but dissents to that portion of paragraph 25 which allows elimination of material weaknesses from a report on the basis that corrective action by management is not practicable in the circumstances. He believes that all material weaknesses should be disclosed since they may be significant to a report user even though corrective action is not practicable. Further, he dissents to paragraph 32 because he believes it is appropriate for an auditor to express an opinion as to the effectiveness of a system of internal accounting control for a particular purpose if an extended special study has been made which was designed for the purpose of expressing such an opinion.

Mr. Krebs assents to the publication of this Statement but joins Messrs. Fitzgerald and Magill in their dissent (below) to the provisions of paragraphs 24 through 26.

Messrs. Fitzgerald, Kell and Kist dissent to the issuance of this Statement because of the arbitrary reporting restrictions imposed by paragraph 32. They believe that a certified public accountant should be permitted to express the opinion that is justified by his findings when the examination is designed for the specific purpose of expressing such opinion and includes all procedures considered necessary in the circumstances.

Messrs. Fitzgerald and Magill dissent to the issuance of this Statement because of the provisions of paragraphs 24 through 26. They believe it is inappropriate to prescribe for public reporting the kind of report required in these paragraphs when in their view the Committee has not made clear its position with respect to usefulness of reporting on internal control evaluations, or provided adequate guidance to the auditor as to the underlying standards or principles of internal control for a frame of reference against which the auditor may judge his responsibilities for purposes of public reporting.

Mr. Kell dissents also to the issuance of this Statement because he believes its primary thrust discourages the extension of the auditor's service to the general public in this important area. He believes that reports on internal accounting control can be useful to the general public in evaluating management performance, particularly in fiduciary relationships, but he feels the report language required in paragraph 24 will discourage the issuance of such reports to the general public.

NOTE

Statements on Auditing Procedure present the considered opinion of the Committee on Auditing Procedure, which is the senior technical committee of the Institute designated to issue pronouncements on auditing matters. Departures from the Committee's recommendations must be justified by those who do not follow them.

COMMITTEE ON AUDITING PROCEDURE (1970-71)

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